

DEPARTMENT OF STATE REVENUE**SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 96-0635SLOF****CORPORATE INCOME TAX****FOR TAX PERIODS: 1992-1994**

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Issue

Adjusted Gross Income Tax: Business Income

Authority: IC 6-3-1-20, 45 IAC 3.1-1-1-30, The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001).

The taxpayer protests the classification of certain income as business income.

Statement of Facts

The taxpayer is primarily engaged in developing, manufacturing, and marketing consumer, professional, health, and other imaging products and services. After an audit, the Indiana Department of Revenue (department) assessed additional corporate income tax. The taxpayer protested the assessment. A hearing was held and a Letter of Findings was issued on May 30, 2002. The taxpayer requested and was granted a rehearing on the issue of the classification of income from the sale of a division as business rather than non business income.

Adjusted Gross Income Tax: Business Income

Discussion

The taxpayer protests the classification of the income from the 1994 sale of the division that supplied diagnostic products for use in clinical chemistry analysis and immunodiagnositcs. The taxpayer reported this income as non-business income that is not subject to Indiana adjusted gross income tax. The department reclassified this income as business income. As business income, the department apportioned part of it to Indiana and subjected that portion to adjusted gross income tax.

All tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC 6-8.1-5-1 (b).

In The May Department Store Company v. Indiana Department of State Revenue, 749 N.E. 2d 651 (Ind. Tax 2001), the Indiana Tax Court determined that IC 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

The Court looks to 45 IAC 3.1-1-20 and 30 for guidance in determining whether income is business or non-business income under the transactional test. These regulations state “. . . the critical element in determining whether income is ‘business income’ or ‘non-business income’ is the identification of the transactions and activity which are the elements of a particular trade or business.” Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer’s trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer’s purpose in acquiring and holding the property producing income. In May, the Court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. Id. at 664.

The nature of this taxpayer’s business included the development, production and sale of imaging products and services. Almost all of the taxpayer’s income derived from transactions associated with these activities. The division that the taxpayer sold was accounted for and run as a separate business unit for the ten-year period prior to its sale. The sale of the medical imaging division was an unusual and out of the ordinary transaction for the taxpayer. The sale of this division did not meet the transactional test for classification as business income.

The functional test focuses on the property being disposed of by the taxpayer. Id. at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to the taxpayer’s regular or business operations. Id. at 664. The Court in May defined “integral” as part or constituent component necessary or essential to complete the whole. Id. at 664-5. The Court held that the May’s sale of one of its retailing division was not “necessary or essential” to May’s regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not May. In essence, the Court determined that because May was forced to sell the division in order to reduce its competitive advantage, the sale could not be integral to May’s business operations. Therefore, the proceeds from the sale were not business income under the functional test.

In the original Letter of Findings, the department found that the taxpayer’s proceeds from the sale of the health imaging business were business income because the payment of the long term debts allowed the taxpayer to focus more funds to the development and management of its consumer photography business. The taxpayer argued at the rehearing that the proceeds from the

sale were not business income because the taxpayer did not use the proceeds in the working capital of its primary function.

In 1988, the taxpayer financed the acquisition of its health imaging business with long-term debt contracts. Management subsequently decided to terminate its involvement in the health imaging business and divested its interests in 1994 and 1995. The taxpayer contended that it put the proceeds from the sale into an irrevocable trust to satisfy the long-term debt originally incurred as part of the acquisition of the health imaging business, the proceeds from the sale did not qualify as business income to the taxpayer.

The taxpayer presented a copy of the Irrevocable Trust Agreement dated December 19, 1994. The taxpayer was not able, however, to produce any evidence that the monies received from the sale were actually the same monies deposited into the trust. In fact, the taxpayer explained that no “paper trail” existed to substantiate that the proceeds of the sale went directly into the trust. The monies deposited into the trust could have been monies raised from another source. The proceeds from the sale made more funds available for the taxpayer’s working capital.

The taxpayer had the same long term debt before and after the sale. The taxpayer needed working capital after the sale and had more funds available for working capital because of the sale. These funds were used to support the taxpayer’s business function. The repayment of these debts was essential to the continuation and completion of the whole of the taxpayer’s business selling imaging products and services.

The taxpayer did not sustain its burden of proving that the tax assessment was incorrect.

Finding

The taxpayer’s protest is denied.